Supreme Court, U.S.
FILED
JAN 12 1993
OFFICE OF THE CLERK

No. 92-873

IN THE

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,
Petitioner,

vs.

CYNTHIA MALESKI, Acting Insurance Commissioner of the Commonwealth of Pennsylvania as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

REPLY BRIEF OF ALLSTATE INSURANCE COMPANY

JOSEPH F. HUTCHINSON, JR.
Counsel of Record
BROUSE & MCDOWELL
500 First National Tower
Akron, Ohio 44308
(216) 535-5711
Attorneys for Petitioner
Allstate Insurance Company

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—TEL. (216) 621-5647

TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

I. Evidentiary Status of Petitioner's Contracts 1

II. Disguised Liquidation 2

III. *Neblett* Analysis 4

A. The Plan's effect on setoff rights 4

B. The Plan's effect on Petitioner's rights as a secured creditor 6

IV. *Energy Reserves* 7

V. Arbitration Rights 8

VI. The Issues Raised in the Petition are of Great National Importance 9

CONCLUSION 10

TABLE OF AUTHORITIES

Cases

Energy Reserves Group, Inc. v. The Kansas Power and Light Company, 459 U.S. 400 (1983) 6,7

In re American Investors Assurance Co., 521 P.2d 560 (Utah 1974) 3

Neblett v. Carpenter, 305 U.S. 297 (1938) 4,6,7

Southland Corp. v. Keating, 465 U.S. 1 (1984) 9

State Statutes

P.S. §§221.14-221.18 2

P.S. §221.18 3,5

P.S. §§221.19-221.52 2

P.S. §221.20(d) 5

P.S. §221.32 5

No. 92-873

IN THE

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,
Petitioner,

vs.

CYNTHIA MALESKI, Acting Insurance Commissioner
of the Commonwealth of Pennsylvania as Rehabilitator
of The Mutual Fire, Marine & Inland
Insurance Company, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

REPLY BRIEF OF ALLSTATE INSURANCE COMPANY

This Reply Brief of Petitioner, Allstate Insurance Company, addressing matters first raised in the Brief in Opposition (hereafter, "Respondent's Brief"), is filed pursuant to Supreme Court Rule 15.6.

Petitioner seeks review of a decision of the Pennsylvania Supreme Court which approved a plan of rehabilitation (the "Plan") for an insolvent insurance company, The Mutual Fire, Marine & Inland Insurance Company ("Mutual Fire"). The Petition raises federal constitutional challenges to (1) the Plan's abrogation of Petitioner's contractual arbitration rights and (2) the Plan's impairment of Petitioner's contractual setoff rights and contractual rights in respect of its collateral.

A response to Respondent's Brief is necessary because Respondent made specious arguments to support its claim that Petitioner will receive under the Plan at least what it would receive on liquidation. The Plan blatantly ignored state statutes dealing with the liquidation of insurance companies. The Plan was a means by which the Rehabilitator could reshuffle liquidation priorities amongst various creditor groups. The lower courts approved the Plan because they thought it was for the good of all. However, the Plan provides substantially less to Petitioner than what Petitioner would receive on liquidation. Thus, Petitioner's contractual rights were unconstitutionally abrogated.

I. Evidentiary Status of Petitioner's Contracts.

Respondent argues that Petitioner waived any Contracts Clause or Due Process Clause challenges to the Plan provisions dealing with setoff because the contracts were not introduced into evidence at the hearing before the Commonwealth Court (Resp. Brief at

21). She is wrong. The Commonwealth Court admitted Cedents' Exhibit 1 as evidence of the standard reinsurance contract which contained setoff provisions. The Commonwealth Court specifically overruled an objection by Respondent that the cedents, including Petitioner, could not rely on a standard clause for their arguments but instead should be required to introduce the approximately 8,000 different contracts in use (Tr. at 355-56). Finally, the record is replete with testimony as to the existence in the cedents' contracts of setoff provisions allowing precisely that to which Petitioner claims it is constitutionally entitled (Tr. at 355, 435, 451).

II. Disguised Liquidation.

The Pennsylvania legislature enacted two sets of statutes governing insolvent insurance companies, one providing for liquidation, P.S. §§221.19-221.52, and the other providing for rehabilitation, P.S. §§221.14-221.18. Presumably, the legislature had a reason for doing so. However, Respondent and the Pennsylvania courts, in an effort to impose a public policy different from that expressed by the legislature, ignored those statutes. In the lower courts, Respondent devised out of whole cloth a new scheme for liquidating an insurance company through a plan of rehabilitation. Respondent obviously did this for the purpose of providing her own liquidation priority scheme which treats creditor priorities different from the priorities under the liquidation statutes.[1]

Respondent's accusation that Petitioner misled this Court by referring to Mutual Fire as a "defunct" insurer is absurd. Even the Commonwealth Court was forced to

[1] Petitioner believes that this was done to prefer policyholders over other creditors, including Petitioner; but whatever the motive, the Plan provides significantly less to Petitioner than Petitioner would receive on liquidation.

recognize that, "of course, no one disputes that the rehabilitation as proposed contemplates the windup of Mutual Fire's current business. . . ." (Pet. App. at A50). Mutual Fire will never again operate as an insurance company. Mutual Fire has written no insurance business since 1986, and neither the Plan nor the financial projections used in obtaining approval of the Plan contemplated any income from new business (Tr. at 210). There was no evidence that the Rehabilitator, or anyone else for that matter, thought or intended that Mutual Fire would ever write new business. For all intents and purposes Mutual Fire is a defunct insurance company.[2]

The Pennsylvania Supreme Court stated that because the Plan provides flexibility and the accelerated disposition of claims, the Plan is preferable to liquidation (Pet. App. at A14). The court then stated, ". . . we affirm the Commonwealth Court's holding that this is a legitimate plan of rehabilitation intended for the benefit of the public and not a *de facto* plan of liquidation." (Pet. App. at A15).

The Pennsylvania statutes provide for liquidation of insurance companies which cannot be rehabilitated. P.S. 221.18. Were the liquidation statutes not passed for the benefit of the public? When the court referred to "flexibility" as a reason for preferring the Plan over

---

[2] The Pennsylvania Supreme Court also stated that the Plan met the requirements for rehabilitation because it required Mutual Fire to retain its nominal required capital and surplus minimums. Notwithstanding the maintenance of a corporate shell, Mutual Fire's insurance business ceased to exist in 1986 and for all practical purposes will not exist again. Courts passing on this precise issue have held that state rehabilitation statutes can properly be invoked only to "rehabilitate" the business of insurance of the insolvent entity, and that the continued existence of the corporate shell is irrelevant to the analysis. *E.g., In re American Investors Assurance Co.*, 521 P.2d 560, 561-62 (Utah 1974).

statutory liquidation, the court actually was referring to the Rehabilitator's scheme of changing the liquidation priorities from the priorities set forth under the liquidation statutes.

The fact that Mutual Fire should have been liquidated under the liquidation statutes is relevant to the analysis that this Court must make in determining whether to grant the Petition. The Plan was intended to shift the liquidation priorities of Mutual Fire's creditors, ostensibly for the benefit of the public. However, the Plan unconstitutionally abrogated Petitioner's rights because Petitioner receives substantially less under the Plan than it would receive on liquidation.

III. *Neblett* Analysis.

A. The Plan's effect on setoff rights.

A review of the Plan as amended by the Commonwealth Court demonstrates that, notwithstanding Respondent's assertions, Petitioner will not receive under the Plan substantially all that Petitioner would receive if Mutual Fire were liquidated as required by this Court's decision in *Neblett v. Carpenter*, 305 U.S. 297 (1938). Under the Plan, Petitioner's setoff rights are limited to a dollar amount equal to the paid losses in existence on December 4, 1986. Resp. Brief at 16-17 & n.11. December 4, 1986 is the date the Insurance Commissioner petitioned to place Mutual Fire into rehabilitation. The Pennsylvania courts incorrectly assumed that the *Neblett* decision required the court to analyze what creditors or policyholders theoretically would have received if Respondent had petitioned for liquidation at the time Respondent filed the original petition for rehabilitation (*i.e.*, December 4, 1986) (Pet. App. at A20-23).

The appropriate analysis, however, is to determine whether creditors will receive under the Plan at least what those creditors would receive if the company were liquidated at the time the court considered approving the Plan. This conclusion is supported by the Pennsylvania statutes. Section 221.18 of the Pennsylvania Statutes provides that the Rehabilitator can petition the court for a liquidation order if prior attempts to rehabilitate the insurer have proven futile. If a liquidation order is entered, the rights of the parties for purposes of liquidation under the Pennsylvania statutes (including the setoff provision in P.S. §221.32) are fixed as of the date of the petition for liquidation. P.S. §221.20(d). The statutes do not contain a similar provision fixing the rights of the parties in a rehabilitation proceeding.

At some point Respondent became aware of the futility of the rehabilitation of Mutual Fire's business. At this juncture Respondent had two choices: petition for a liquidation order, P.S. §221.18, or press the Commonwealth Court to approve a liquidating rehabilitation plan which provided creditors what they would receive on liquidation.

Had Respondent petitioned for liquidation, the ensuing liquidation order would have had the effect of fixing Petitioner's setoff and other rights as of the date Respondent petitioned to convert the case to a liquidation proceeding (*i.e.*, no earlier than 1990). P.S. §§221.18, 221.20(d). In the interim between the original petition for rehabilitation in 1986 and the time when Respondent would have petitioned for liquidation in 1990, many of the mutual obligations between Mutual Fire and Petitioner, in the form of case reserves and IBNR, matured into paid losses, thus substantially increasing Petitioner's setoff rights.

Instead, however, Respondent chose to file a liquidating plan which purported to fix Petitioner's rights retroactively as of December 4, 1986, even though no liquidation order had ever been entered which would have fixed Petitioner's rights. By this act, Petitioner's contractual setoff rights were substantially impaired because Petitioner's paid losses were much greater in 1990 than they were on December 4, 1986.

This impairment violates Petitioner's constitutional rights. This is not merely a matter of a state court interpreting state law. This is a matter of a state court misapplying a federal constitutional standard. In her zeal to provide liquidation priorities for creditors different from the priorities set forth in the liquidation statutes, Respondent ignored state law in derogation of Petitioner's constitutional rights guaranteed by *Neblett*. It is beyond dispute that this Court has jurisdiction to review such issues. *Energy Reserves Group, Inc. v. The Kansas Power and Light Company*, 459 U.S. 400 (1983).

B. The Plan's effect on Petitioner's rights as a secured creditor.

Notwithstanding Respondent's assertion that Petitioner's rights to its collateral are unaffected by the Plan, Petitioner receives under the Plan far less favorable treatment as a secured creditor than Petitioner would receive on liquidation. Respondent concedes that collateral trusts and letters of credit secured cedents' claims for paid losses, case reserves and IBNR (Tr. at 215, 216). Respondent further concedes that under the Plan, a secured cedent's resort to its collateral is limited to drawing from a collateral trust or drawing down on letters of credit only for paid losses as those losses develop over time. *Id.*

Petitioner's contractual rights have been substantially impaired because Petitioner (a cedent) is not permitted by the Plan to resort to the collateral for all of the obligations owed it by Mutual Fire, including case reserves and IBNR. As Petitioner argued in its brief to the Pennsylvania Supreme Court at pages 20-37, in a liquidation, the Pennsylvania statutes allow secured creditors to obtain all their collateral. This would include the right to use collateral to pay case reserves and IBNR, in addition to paid losses. Petitioner's rights are also impaired by the Plan's requirement that Petitioner obtain Respondent's permission before resorting to the collateral. Petitioner has been denied Respondent's permission to resort to its collateral for the three years since the Plan was approved—indeed, for the seven years since Respondent took control of Mutual Fire. As a result, Petitioner has been denied the use of its collateral, and the opportunity to invest the proceeds of the collateral. Petitioner's rights as a secured creditor are unconstitutionally impaired by the Plan under the *Neblett* standard.

IV. *Energy Reserves.*

Neblett is the gauntlet which protects the rights of creditors in insurance insolvency and rehabilitation proceedings. If *Energy Reserves Group* means that a state may impair contractual interests if it rests on and is prompted by significant and legitimate state interests, such state interests do not exist with respect to the liquidation of Mutual Fire.

Under *Energy Reserves*, this Court recognized that the State of Kansas exercised its police power by enacting statutes to protect consumers from the escalation of natural gas prices caused by deregulation and that the state had a legitimate interest in correcting the imbalance between the interstate and intrastate

markets. In this case, there cannot possibly be a legitimate state interest to protect by approving a rehabilitation plan which liquidates Mutual Fire in a manner which is different from the way it would be liquidated under the state's extant liquidation statutes. Thus, the Commonwealth of Pennsylvania had no legitimate state interest in abrogating Petitioner's contract rights, and for that reason Petitioner's constitutional rights were violated.

V. Arbitration Rights.

As explained in the Petition, Section X of the Plan provides that a party to a dispute may request the Commonwealth Court to hear the dispute in lieu of arbitration. The court is required to grant the request if it is in the best interest of the estate (Pet. App. A112). It is clear that the Plan approved by the Pennsylvania courts does not require arbitration in all cases where the dispute is governed by a contractual arbitration clause. In fact, Respondent admits that, under the Plan, whether or not to allow arbitration of a given dispute is to be determined in the discretion of the Commonwealth Court on a case-by-case basis (Resp. Brief at 13). In Respondent's view, granting discretion to the Commonwealth Court does not constitute an abrogation of Petitioner's arbitration rights because, the argument goes, the court *might* allow Petitioner to arbitrate its disputes. *Id.*

However, the possibility that a court might allow arbitration of a dispute governed by an arbitration clause was not good enough for the United States Congress when it enacted the Federal Arbitration Act. Congress obviously was concerned with the possibility that a court *might not* allow arbitration. The Supremacy Clause requires the Commonwealth of Pennsylvania to enforce

the Federal Arbitration Act in all cases governed thereby. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). The Pennsylvania courts may not approve a rehabilitation plan for an insolvent insurance company which, by its terms, is contrary to the requirements of the Act.

Contrary to Respondent's assertions, this issue is ripe for adjudication because the Plan abrogates the Petitioner's rights to arbitration by making such rights dependent upon a Pennsylvania court's discretion. The contractual arbitration rights have already been abrogated by the Plan itself.

Respondent also argues that Petitioner waived this issue in the courts below (Resp. Brief at 11-14). On the contrary, Petitioner did not waive the issue, and the record is sufficiently developed to permit this Court's review. As stated in its Petition at 6-8, Petitioner challenged the denial of its arbitration rights, and Respondent specifically addressed the issue of the apparent conflict between the Federal Arbitration Act and the McCarran-Ferguson Act in her brief to the Pennsylvania Supreme Court (Rehabilitator's Brief to Penn. S. Ct. at 90).

VI. The Issues Raised in the Petition are of Great National Importance.

Respondent's Brief improperly portrays as trivial the impairment of Petitioner's contractual rights. This is obviously an attempt to persuade this Court that the matters presented in the Petition are too insignificant to justify a commitment of the Court's limited resources. The reinsurance business in the United States is a multi-billion dollar industry. If states are free to affect the rights of participants in the industry in the manner accomplished by the Pennsylvania courts, the effect on

the reinsurance industry will be tremendously adverse. The issues presented in this case are of national importance and justify the commitment of this Court's resources to their resolution.

CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,

JOSEPH F. HUTCHINSON, JR.
Counsel of Record
BROUSE & MCDOWELL
500 First National Tower
Akron, Ohio 44308
(216) 535-5711
Attorneys for Petitioner
Allstate Insurance Company